EXHIBIT 1

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West Bank and Gaza Public Expenditure Review Volume 2

From Crisis to Greater Fiscal Independence

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Increased scarcity of jobs has led to more part-time workers. The share of workers reporting that they work less than full time has increased steadily the past year. In the third quarter of 2006 the share reached 11.6 percent, up from 7.3 percent in the fourth quarter of 2004.[6] Employment data for the fourth quarter of 2006 is scheduled to be released in February 2007. Projections based on the current situation would estimate further job-losses, although the olive-harvest was reportedly exceptional this year, and may have led to an increase in temporary job creation.

According to the IMF (2006), the banking sector remains relatively sound, despite the depressed economy. Private sector deposits continue to grow, albeit slowly, and banks are liquid. While banks have a sizable exposure to the PA and to its employees, the situation should be manageable, at least for the near future. PIF assets guarantee a large part of bank loans to the PA, and the PA employees' debt service obligations currently due are small. Some banks recently deducted small amounts from the latest partial wage payment to government employees to help cover interest due. Banks did not suffer much from the decline in the stock market—a fall of about 50 percent since mid-January 2006—as their exposure was fairly limited and the book values of equity investments had not reflected the substantial gains made prior to the drop in share prices.

3. Fiscal Trends—A Brief Historical Review

In its early years, the PA's revenues increased rapidly. During the five-year period from 1995 (the first full year of the PA's functioning) to 1999, the PA's revenues almost doubled, from $510 million in 1995 to $942 million in 1999. The main driver was a rapid increase in clearance revenue, which reached $580 million in 1999, 62 percent of the total revenues for the year. Domestic revenues also increased strongly, due to the rapid establishment of tax collection capacity in the West Bank and Gaza. By 1999, the revenue-to-GDP ratio had reached 22.6 percent, up from 15.8 percent in 1995 (see table 1.1).[7]

The outbreak of the *intifada* in 2000 and the associated economic crisis had an immediate negative impact on PA revenues. In July 2000, PA revenues reached their pre-*intifada* peak at $95 million. By December 2000—three months into the *intifada*—revenues had declined to $49 million, a decline of roughly 50 percent.[8] The steep decline reflected tightened restrictions on the movement of goods in and out of the West Bank and Gaza, and cutbacks in Palestinian consumer spending, both of which reduced imports. Consequently, fewer trade taxes were collected by the Government of Israel on behalf of

[6] The number of hours worked by those who report being under-employed is unknown. Assuming that they work half-time, the increase in the share of under-employed has resulted in a 2.2 percent decline in the total number of man-hours.

[7] Following the increase in revenue collection, concerns about transparency in public finances emerged, particularly concerning the diversion of tax revenues to accounts outside the control of the Ministry of Finance, the growth in semiprivate PA investments and the unauthorized revenue collection by various PA entities, notably the security services (Brynen 2005; IMF 2003). Significant improvements in public financial management were carried out from 2002 onward and redressed many of the past deficiencies (World Bank 2004).

[8] These revenue figures include clearance revenue collected by GOI but not transferred during 2001–02.

the PA. The moribund economy kept PA revenues at an average of $52 million per month through 2002. Beginning in 2003 revenues gradually started to recover. By December 2003, revenues (in nominal terms) reached pre-*intifada* levels for the first time.

Box 1.1: Clearance Revenue

The Paris Protocol of Economic Relations of 1994 established the guidelines for a revenue clearance system between the GOI and the PA. Under the operation of the quasi-customs union, Israel collects a duty on foreign imports entering the West Bank and Gaza, as well as a VAT for Israeli products destined to the Palestinians. Indirect tax collection is based on actual payments or bookkeeping transactions and has a unified invoice system to support the claims. For custom duties, VAT, and purchase taxes on third- party goods imported by Palestinian companies for the West Bank or Gaza, a code sharing system ensures the correct amounts are being transferred. Indirect taxes like the VAT are collected and transferred to each side after the reconciliation of accounts and according to a "destination principle." At the end of the month, the PA reports the amount of taxes collected by Israel, and the Israeli administration, conversely reports its share collected by the PA, over which a net claimed is settled. The GOI charges a 3 percent handling fee of the total gross clearance revenue collection.[9] For direct taxes paid by Palestinian workers in Israel and its controlled areas the Protocol established that the income tax collection should be shared by both governments. Therefore, the PA keeps 100 percent of the health fees and receives 75 percent of the income tax under the assumption that workers will most likely consume social services in the West Bank and Gaza.

Clearance revenues were transferred on a monthly basis up to the start of the second *intifada* in 2000. Transfers were suspended by the GOI in December 2000 and only resumed in late 2002. Clearance revenues are the most important source of income for the PA, accounting for two thirds of total revenue (see the table below). Gross clearance transfers amounted to US$757 million for 2005, equivalent to US$63 million per month. Thus, the decision of the GOI to stop transferring clearance revenue by mid – February after Hamas' election victory at the January 25 Parliamentary elections resulted in an average revenue shortfall of about US$ 60 million per month for the PA treasury.

PA revenues (US$ millions)[10]

	2001	2002	2003	2004	2005
Revenue	275	295	763	954	1,233
Domestic revenue	275	223	291	337	476
Tax revenue	183	141	167	191	231
Non tax revenue	92	82	124	146	245
Clearance revenue[11]	0	72	472	617	757

Source: IMF and MOF

The GOI's decision to stop transferring clearance revenue is a violation of the Oslo accords, under which there is no clear provision for Israel to withhold clearance revenues. It is not illegal under Israeli law, which grants such discretion to the Minister of Finance and recognizes international agreements only to the extent that their provisions have been ratified by the Knesset. A case was brought to the Israeli Supreme Court in which the petitioners sought to force the GoI to release the funds. However, the Supreme Court rejected the petition, and in so doing agreed with the GoI that withholding the funds was within the discretion of the Minister of Finance to prevent the funding of terrorist activities. In terms of international law, the issue is open to debate.

[9] West Bank and Gaza Strip: Economic Developments in the Five Years Since Oslo, IMF, November 1999
[10] Economic Monitoring Note, World Bank, Spring 2006
[11] Clearance revenue figures include VAT refunds.

In the initial Oslo period, the PA's recurrent expenditures increased rapidly but were broadly in line with revenues. High initial growth in public expenditures and staffing were expected as a new government apparatus was to be set up basically from scratch. However, the increase also reflected attempts to integrate returning Palestine Liberation Organization employees into the public service and to absorb workers being repatriated, mainly from Gulf countries, in the wake of the first Gulf war and for this reason expenditure growth clearly exceeded what was necessary for the PA to take up its new responsibilities (World Bank 1999). Public employment increased from 57,000 in 1995 to 99,000 in 1999, an annual staffing growth of almost 13 percent.[12] The concurrent growth in the wage bill amounted to approximately 14 percent a year, implying a relatively modest increase in average public salaries of 1–2 percent a year. By 1999 public expenditures amounted to 22.6 percent of GDP, or some $78 million per month, and were fully covered by PA revenues, leaving a balanced recurrent fiscal position.

[12] Thus, in this period, the growth in the public payroll outpaced population growth by more than 2 to 1.

Table 1.1: PA Fiscal Operations, 1995-2005
(millions of dollars)

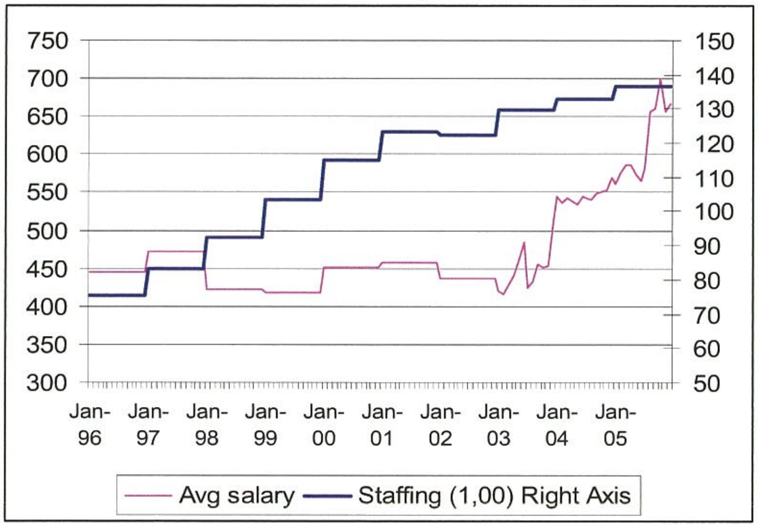
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Revenue	510	645	807	868	942	939	275	296	763	954	1,232
o/w Gross domestic	244	294	331	324	362	352	275	224	291	337	476
o/w Tax	144	208	213	228	248	241	183	141	167	191	231
o/w Nontax	100	86	118	97	114	111	92	82	124	146	245
o/w Gross clearance	266	352	476	544	580	587	0	72	472	617	757
Total expenditure (including net lending and VAT refunds)	578	781	862	838	937	1,212	1,119	1,022	1,292	1,528	1,994
Recurrent expenditure	578	781	862	838	937	1,199	1,095	994	1,067	1,320	1,594
o/w Wages	304	403	470	467	519	622	678	642	743	870	1,001
o/w Civil service	194	na	na	na	320	378	426	404	456	538	614
o/w Security services	110	na	na	na	199	244	252	239	288	333	387
o/w Nonwage expenditures	274	377	392	372	418	577	417	352	324	449	593
o/w Operating	na	na	na	na	na	na	na	na	124	193	179
o/w Transfers	na	na	na	na	na	na	na	na	201	257	375
o/w Debt service	13	10	9	16	17	7	–1	6	10	25	39
PA-financed capital expenditure	0	0	0	0	0	13	22	23	36	36	44
Balance	68	135	55	30	5	274	842	721	340	402	406
Net lending	0	0	0	0	0	0	0	0	173	157	344
VAT refunds	0	0	0	0	0	0	2	5	16	16	12
Overall balance	68	–135	–55	30	5	274	844	726	529	574	762

Source: Ministry of Finance, IMF, and World Bank staff estimates.

Despite the revenue crunch during the *intifada*, the PA's wage bill continued to increase at a rate of 11 percent a year between 1999 and 2005. Compared with the pre-*intifada* period, the increase was driven more by increases in average public sector salaries than by higher payroll numbers. Nevertheless, by the end of 2005, 137,000 persons were on the PA payroll, compared with 104,000 at the end of 1999, an average annual growth of 4.7 percent. The period 2003–05 witnessed two large salary hikes. The first occurred in late 2003 when part of the wage increase envisaged in the Civil Service Law, pending since 1998, was implemented. As a result, average wages in the first quarter of 2004 jumped more than 20 percent compared with levels a year before. There was another 20 percent increase in average salaries in the second half of 2005.

In the last quarter of 2005, the average salary for a PA employee reached $676 per month, up from $559 the year before, an increase of 21 percent (figure 1.7). The second round of salary increases disproportionately benefited security service staff relative to civil servants.[13] At the beginning of 2003 civil servants earned 20 percent more on average than security service staff. By the end of 2005 the difference had narrowed to less than 5 percent.

Figure 1.7: Palestinian Authority Staffing and Average Public Sector Salary



Note: The average salary is calculated by dividing the monthly wage bill with the year-end staffing levels; thus, the monthly variations in the average salary reflect wage bill variations and should be treated with some caution, though the trend is believed to be robust.
Source: Ministry of Finance, International Monetary Fund and World Bank staff calculations.

[13] Average wage numbers are subject to several uncertainties. First, monthly payroll data do not exist for the entire period. Only year-end data are available, and monthly data have been linearly interpolated from the annual data. Second, payroll data for the security services are particularly weak because the security service payroll is not fully controlled by the MOF. The quoted figures are based on MOF data; if payroll figures underreported the actual number of staff, the calculated average salaries would be similarly overestimated.

Since 2003 the PA has increasingly been the "financier of last resort" covering unmet financial obligations for other public entities, among them chiefly the following:

- The PA settles utility bills from Israeli suppliers that municipalities have not paid. Municipalities, in particular in the West Bank, are the main retail providers of water and electricity. These payments are "netted out" from the monthly transfer of Palestinian customs revenue and amounted to a total of $132 million in 2005 ($11 million a month).
- The PA has a contractual obligation to supply fuel for power generation by the Gaza Electricity Company, which cost $119 million in 2005 ($9 million a month).
- The PA must make payments to the Petroleum Commission, the PA owned monopoly importer of petroleum products. The Petroleum Commission sells its product at a loss, which has to be covered by the PA. In 2005 this amounted to $98 million, or $8 million a month (table 1.2).

Table 1.2: Net Lending in 2005
(millions of dollars)

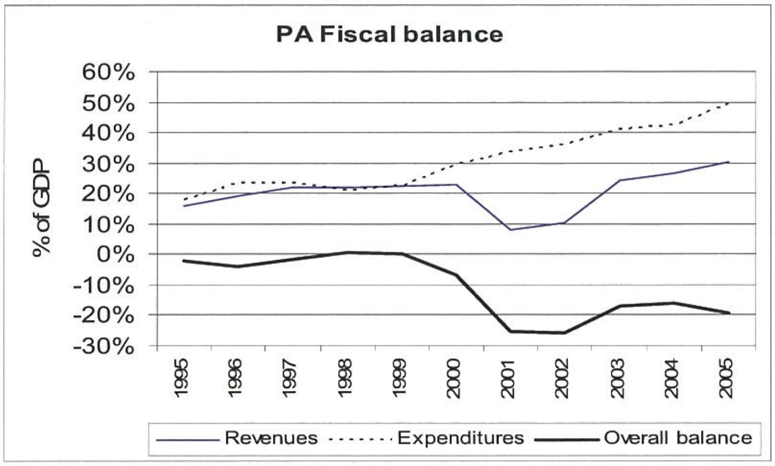
	Monthly	Annual
Deductions from clearance revenue by government of Israel	11.0	132
Electricity	8.3	100
Water	2.5	30
Sewage	0.2	2
Direct payments from PA	17.7	212
Gaza Electricity Company	9.9	119
Petroleum Commission	8.2	98
Other (negative number implies repayment to the PA)	–0.4	0.5]
Total	**29**	**344**

Source: Ministry of Finance, International Monetary Fund.

Continued expenditure expansion in the context of the economic crisis during the *intifada* resulted in a rapid increase in the expenditure-to-GDP ratio. By 2005 the ratio had more than doubled from its 1999 level of 22.6 percent to 49 percent, one of the highest ratios in the world. Of the 122 countries for which the World Development Indicators report central government expenditures, only Eritrea was higher, at 53 percent in 2004.[14]

[14] It should be noted that figures for other countries include capital expenditures, while the data for the PA does not.

Figure 1.8: Palestinian Authority Fiscal Balance



Source: Ministry of Finance, International Monetary Fund and World Bank staff estimates.

4. The Current Fiscal Crisis

The Palestinian Authority (PA) is experiencing an acute fiscal crisis.[15] During the first six months after the new Palestinian Government was sworn in, domestic tax revenues (on a cash basis) amounted to only $17 million per month, compared to $104 million during the same period a year earlier (table 1.3). Commercial banks significantly reduced their exposure to the PA government, mainly for fear of possible legal repercussions abroad. Banks reduced credit lines by offsetting their tax liabilities and by withholding other revenues accruing in the MOF's bank accounts against credit previously extended to the PA. Also, banks did not roll over loans falling due. The IMF estimates that bank loans to the PA were reduced by an average of $25 million per month between March and September 2006. By contrast, in the same period last year, commercial banks increased their lending to the PA by about $30 million a month. Outstanding PA debts to commercial banks (including banks abroad) as of end-September 2006, are estimated at about $500 million down from a peak of $695 million in February 2006.

[15] For a more in-depth analysis of the PA's fiscal crisis, see *Recent Fiscal and Financial Developments*, IMF, October 2006.